

Part III - Administrative, Procedural, and Miscellaneous

Examples Under Section 937(b)

Notice 2006-76

SECTION 1. PURPOSE

This notice provides additional examples to illustrate and confirm the application of section 937(b) and Temp. Treas. Reg. §§ 1.937-2T and -3T in determining whether income is derived from sources within a U.S. possession or territory specified in section 937(a)(1) (hereinafter “U.S. territory”) or whether income is effectively connected with the conduct of a trade or business within a U.S. territory. The examples address solely the application of the rules under section 937(b) and do not address any other issue, including the circumstances in which a taxpayer would be engaged in the conduct of a trade or business within the United States within the meaning of section 864 or how any transaction should be appropriately characterized. The Treasury Department and the Internal Revenue Service (IRS) intend to include these or substantially similar examples in additional guidance to be provided on the application of the so-called *U.S. income rule* in final regulations under section 937(b). Until additional examples are included in final regulations, taxpayers may treat the examples set forth in this notice as illustrative of the rules in the temporary regulations.

SECTION 2. BACKGROUND

.01 Section 937(b)

Section 937 was added to the Internal Revenue Code by section 908 of the American Jobs Creation Act (Public Law 108-357). Section 937(a) provides rules for determining whether an individual is a bona fide resident of a U.S. territory. Section 937(b) provides rules for determining whether income is derived from sources within a U.S. territory and whether income is effectively connected with the conduct of a trade or business within a U.S. territory. Section 937(b)(1) provides that, except as provided in section 937(b)(2), rules similar to the rules for determining whether income is income from sources within the United States or is effectively connected with the conduct of a trade or business within the United States shall apply for purposes of determining whether income is from sources within a U.S. territory or effectively connected with the conduct of a trade or business within a U.S. territory.

Section 937(b)(2) sets forth the U.S. income rule, which provides that income treated as income from sources within the United States or as effectively connected with the conduct of a trade or business within the United States is not treated as income from sources within a U.S. territory or as effectively connected with the conduct of a trade or business within a U.S. territory. Section 937(b) grants the Secretary regulatory authority to provide exceptions to the rules provided in sections 937(b)(1) and (b)(2).

.02 Treasury Regulations under section 937(b)

On April 11, 2005, Treasury and the IRS published in the Federal Register temporary regulations (TD 9194, 70 FR 18920-01, as corrected at 70 FR 32489-01), which provided rules to implement section 937 and to conform existing regulations to other legislative changes with respect to U.S. territories. A notice of proposed rulemaking (REG-159243-03, 70 FR 18949-01) cross-referencing the temporary regulations was published in the Federal Register on the same day. A public hearing was held on July 21, 2005. Final regulations relating to the residence rules under section 937(a) were issued as T.D. 9248 on January 31, 2006. Final regulations under section 937(b) will be issued in a forthcoming Treasury decision.

In general, the proposed and temporary regulations under section 937(b)(1) provide that the principles of sections 861 through 865 and the regulations thereunder are to be applied in determining gross and taxable income from sources within and without a U.S. territory. See Temp. Treas. Reg. § 1.937-2T(b). The proposed and temporary regulations further provide that the principles of section 864(c) and the regulations thereunder are to be applied in determining whether income is effectively connected with the conduct of a trade or business in a U.S. territory. See Temp. Treas. Reg. § 1.937-3T(b).

The proposed and temporary regulations under section 937(b)(2) incorporate the U.S. income rule, which limits application of the principles of the source and effectively connected income rules under sections 861 through 865 in order to prevent erosion of the U.S. tax base. See Temp. Treas. Reg. §§ 1.937-2T(c)(1) and -3T(c)(1); see also

H.R. Rep. No. 108-755, at 794 (2004). Although the proposed and temporary regulations include several examples applying section 937(b) and Temp. Treas. Reg. §§ 1.937-2T and -3T, some of the comments received by Treasury and the IRS indicate an urgent need for additional examples illustrating the operation of the U.S. income rule. Accordingly, this notice provides two such examples.

Treasury and the IRS plan to include these or substantially similar examples in final regulations. Until regulations under section 937(b) are issued in final form, taxpayers may treat the examples set forth in this notice as illustrative of the rules in the temporary regulations. In addition, Treasury and the IRS continue to consider comments received that have requested exceptions or other modifications to the U.S. income rule.

SECTION 3. EXAMPLES

The following examples illustrate the application of section 937(b):

Example 1. (i) Facts. Corporation A, a corporation organized in a U.S. territory (Territory X), is engaged in a business consisting of the development of computer software and the sale of that software. Corporation A has its sole place of business in Territory X. Assume for purposes of this example that Corporation A is not engaged in the conduct of a trade or business in the United States. Corporation A receives orders for its software from customers in the United States and around the world. After orders are accepted, Corporation A's software is either: (1) loaded onto compact discs at Corporation A's Territory X facility and shipped via common carrier, or (2) downloaded from Corporation A's server in Territory X. The sales contract provides that the rights,

title, and interest in the product will pass from Corporation A to the customer either at Corporation A's place of business in Territory X (if shipped in compact disc form) or at Corporation A's server in Territory X (if electronically downloaded). Assume for purposes of this example that each transaction is classified as a sale of a copyrighted article under Treas. Reg. §§ 1.861-18(c)(1)(ii) and (f)(2).

(ii) Analysis. Under the principles of section 863(a), as applied pursuant to Temp. Treas. Reg. § 1.937-2T(b), because Corporation A passes the rights, title, and interest to the copyrighted articles in Territory X, Corporation A's sales income is sourced to Territory X. Corporation A's sales income is also effectively connected with the conduct of a trade or business in Territory X, under the principles of section 864(c)(3) as applied pursuant to Temp. Treas. Reg. § 1.937-3T(b). Corporation A's income is not from sources within the United States, nor is it effectively connected with the conduct of a trade or business in the United States. Accordingly, the U.S. income rule of section 937(b)(2) and Temp. Treas. Reg. §§ 1.937-2T(c)(1) and 1.937-3T(c)(1) does not operate to prevent Corporation A's sales income from being Territory X source and Territory X effectively connected income under section 937(b)(1).

Example 2. (i) Facts. Corporation B, a corporation organized in Territory X, has its sole place of business in Territory X. Assume for purposes of this example that Corporation B is not engaged in the conduct of a trade or business in the United States. Corporation B employs a software business model generally referred to as an "application service provider." Employees of Corporation B in Territory X develop software and maintain it on Corporation B's server in Territory X. Corporation B's

customers in the United States and around the world transmit detailed data about their own customers to Corporation B's server and electronic storage facility in Territory X. The customers pay a monthly fee to Corporation B under a "Subscription Agreement," and they can use the software to generate reports analyzing the data at any time but do not receive a copy of the software. Corporation B's software allows its customers to generate the reports from their location and to keep track of their relationships with their own customers. Assume for purposes of this example that Corporation B's income from these transactions is derived from the provision of services.

(ii) Analysis. Under the principles of section 861(a)(3) and Treas. Reg. § 1.861-4(a), as applied pursuant to Temp. Treas. Reg. § 1.937-2T(b), because Corporation B performs personal services wholly within Territory X, the compensation Corporation B receives for services is sourced to Territory X. Corporation B's services income is also effectively connected with the conduct of a trade or business in Territory X, under the principles of section 864(c)(3) as applied pursuant to Temp. Treas. Reg. § 1.937-3T(b). Corporation B's income is not from sources within the United States, nor is it effectively connected with the conduct of a trade or business in the United States. Accordingly, the U.S. income rule of section 937(b)(2) and Temp. Treas. Reg. §§ 1.937-2T(c)(1) and 1.937-3T(c)(1) does not operate to prevent Corporation B's services income from being Territory X source or Territory X effectively connected income within the meaning of section 937(b)(1).

SECTION 4. EFFECTIVE DATE

The examples in this notice illustrate the principles of section 937(b) and the

temporary regulations, which generally apply to taxable years ending after October 22, 2004, except with respect to the U.S. income rule of section 937(b)(2) and Temp. Treas. Reg. §§ 1.937-2T(c)(1) and 1.937-3T(c)(1), which apply to income earned after December 31, 2004.

SECTION 5. DRAFTING INFORMATION

The principal author of this notice is Cleve Lisecki of the Office of Associate Chief Counsel (International). For further information regarding this notice contact Mr. Lisecki at (202) 435-5262 (not a toll-free call).